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# Peru: Challenges Facing the New Administration

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An Intelligence Assessment

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CR 85-16137  
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December 1985

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# **Peru: Challenges Facing the New Administration**

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**An Intelligence Assessment**

This paper was prepared by [redacted]  
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## Peru: Challenges Facing the New Administration

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### Key Judgments

*Information available  
as of 1 November 1985  
was used in this report.*

Since inaugurated last July, President Alan Garcia—a center-left social democrat—has launched numerous initiatives aimed at alleviating Peru's pressing national problems, which include a deteriorating economy, a persistent leftist insurgency, and an expanding illicit narcotics industry. Garcia's populist appeal and flair for the dramatic have gained him unprecedented public support and have muted criticism from the country's most important interest groups—the military, the legitimate far left, and labor.

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Garcia is determined to reverse Peru's financial decline. Inflation is nearing an annual rate of 200 percent, the budget deficit has swollen to 10 percent of GDP, and exports are declining while capital flight is accelerating. To meet these problems while still addressing his campaign pledges to raise the living standards of the poor, Garcia is implementing a highly nationalistic and socially oriented program that seeks to reactivate the domestic economy through internal market development. To increase revenues to fund his programs, Garcia has decreed that Lima will limit payments on the country's \$14 billion debt to 10 percent of exports over the next year and will not seek a stabilization agreement with the International Monetary Fund.

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The US Embassy believes Garcia is a pragmatist who understands that he cannot produce sustained economic growth—and hence maintain his domestic popularity—without US assistance and private capital investment. Thus, if Peru's financial fortunes continue to decline during his first year in office—which we see as likely—the odds are better than even that Garcia will shift course and adopt a more traditional economic program involving tighter fiscal and monetary policies. We do not discount the possibility, however, that a worsening economic situation could lead the President to adopt more radical positions that include increased government spending for investment and assistance programs.

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Garcia's bold antinarcotics efforts include firing many corrupt senior police officials and authorizing joint antinarcotics operations with security forces from Colombia and the United States. We believe there will be continued progress in this area because the President is personally committed to the antinarcotics struggle. He has strong domestic support on his stand. He

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also desires to promote an issue that will strengthen his leverage with Washington. Garcia will have to take on the more volatile issues of immobilizing Peru's trafficking kingpins and significantly reducing coca cultivation if he is to permanently damage the illicit cocaine industry. [ ]

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On the insurgent front, Garcia has followed a dual approach. While authorizing continued counterinsurgency operations, Garcia has publicly called to account military personnel accused of human rights violations, promised to devote substantial economic resources to civic action programs, and formed a peace commission to examine possibilities for a negotiated solution. We believe Garcia's strategy has potential, but, to succeed, the government will have to follow through on its promises to address the broad range of social and economic problems that have helped fund the insurgency. Increased government spending on rural agricultural projects and other programs for improving the well-being of peasants and urban slumdweller could begin to undercut popular support for the insurgents, but Garcia is unlikely even under the best circumstances to come up with the massive funding for social and economic programs that we believe would be necessary to rally the populace against the guerrillas. [ ]

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Garcia has moved quickly to implement a Third World-oriented foreign policy that is markedly less pro-United States in tone and substance than that of his predecessor. On Nicaragua, for example, Garcia has blamed Washington publicly for confusing a popular revolution with Soviet penetration, and has outspokenly opposed the use of economic sanctions or other coercive measures against the Sandinista regime. Garcia is not viscerally anti-American and has in fact expressed admiration for the United States' democratic system and its economic achievements. His understanding of the United States is superficial, however, and is strongly influenced by his party's historically "anti-imperialist" ideology [ ]

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Although Garcia has toned down his anti-US rhetoric somewhat since taking office, we anticipate he will continue to foster the image of conflict with Washington on occasion, both to distract public opinion from the economic "castor oil" the nation is being asked to swallow, and as part of Garcia's effort to carve out a position of nonaligned leadership for himself. Garcia hopes, for example, that his confrontational approach on the debt issues will propel him to the forefront of Latin American diplomacy. Garcia and Fidel Castro have rivaled each other for leadership on the issue, however, and few Latin leaders have rallied behind either's approach. [ ]

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The Soviet Union has had important equities in Peru since the early 1970s, and Soviet officials are optimistic that with Garcia in power they can expand their involvement. [REDACTED]

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[REDACTED] his actions already are affording the Soviets new opportunities. Garcia has solicited—and obtained—offers for expanded Soviet military and technical training, as well as additional equipment. Moreover, he stated before his election that he hoped he could rely on Moscow and its allies for economic assistance if Western creditors proved inflexible. [REDACTED]

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We believe that Garcia's strong nationalism and the ruling party's anti-Communist tradition will act as a brake on the degree to which his administration will align itself with Moscow. If Peru is unable to reach an accommodation with foreign creditors and the economy takes a nosedive, we believe Garcia might turn increasingly to the USSR for economic and other assistance. We expect Moscow would increase its development aid, purchase more Peruvian commodities, and encourage the assimilation of Peru into Bloc economic relationships. Such a response would bolster Soviet prestige in the eyes of many Peruvians and would greatly strengthen Moscow's prospects for making new inroads in Peru. [REDACTED]

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## Peru: Challenges Facing the New Administration

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### Introduction

Alan Garcia's assumption of the presidency on 28 July 1985 began a new phase in Peru's five-year-old experiment with democracy. His inauguration—only the second peaceful transfer of power between civilian administrations in Peru during this century—marks the first time the center-left American Popular Revolutionary Alliance (APRA), the country's oldest and largest political movement, has headed the government since the party's founding in 1924. Garcia's five-year term is widely viewed by Peruvians as a test of whether the country's intractable socioeconomic problems can be remedied by reform or whether more drastic solutions (which either the far left or the military would offer) will eventually prove necessary.



### Domestic Challenges

#### The Economy

The President's most formidable challenge is the rapidly deteriorating economic situation. By the end of August—a month after Garcia's inauguration—domestic inflation was running at 184 percent annually, and two-thirds of the 6.5 million workers were either jobless or employed in irregular work, according to the US Embassy. Paying the foreign debt has been increasingly difficult because of stagnating exports and increasing capital flight. The country's debt-servicing obligations rose from \$1.7 billion in 1979 to \$2.5 billion last year, and the ratio of debt service to exports reached 76 percent by the end of 1984.

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To remedy this situation, Garcia has charted a course that emphasizes highly nationalistic economic policies aimed at restoring growth and reducing foreign dependence. We judge Garcia's intent to be a self-imposed stabilization program, similar to those in

Garcia, a handsome 36-year-old and a spellbinding orator, captured international attention and the imagination of his countrymen during his run for the presidency. He has maintained strong popular backing during his first four months in office while grappling with a host of formidable difficulties. On the economic front, Garcia publicly admitted that Peru's inflation may reach 250 percent by the end of this year. The recent declaration by US authorities that Peru's debt to US commercial banks was "value impaired" will further complicate Lima's efforts to obtain the resources needed to reactivate the economy. Security problems are also serious. Over the past year, the growing appeal to Peruvian youth of revolutionary solutions was underscored by the emergence of two new terrorist organizations and expanded operations by the entrenched Sendero Luminoso (Shining Path) guerrilla group. At the same time, illicit narcotics trafficking is on the increase.

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Colombia and Venezuela, that would win support from foreign lenders without the need for a formal IMF adjustment program:

- Externally, Garcia has limited debt servicing to 10 percent of export earnings over the next 12 months, promoted joint action among Latin debtors to secure easier repayment terms, strengthened controls over foreign investment, and tightened exchange controls to bolster exports and reduce imports.
- Domestically, Garcia has stressed agricultural development so as to eliminate food imports and has encouraged import substitution behind tariff barriers to reactivate industry. According to the US Embassy, Lima will try to redistribute income and reduce unemployment by obtaining funding from international organizations for employment programs focused on housing, health, transportation, and agriculture. He has promised tax incentives to industrialists who hire more workers. To stabilize the economy, Garcia wants to increase taxes on wealthy individuals and corporations and to balance the budget by tighter planning. [ ]

Garcia has moved swiftly to try to restore growth, improve social welfare, and reduce foreign dependency, but—in our judgment—his piecemeal approach falls short of a coherent reform agenda. To bolster living standards and attack inflation, he lowered domestic interest rates, froze rents, and put price controls on staples for 90 days. He also granted wage hikes to mollify workers and promised technical and financial assistance to farmers. To reduce capital flight, Garcia froze dollar deposits for 90 days and devalued the currency 12 percent. He placed import controls on 300 items to protect industry and foreign exchange. He sought to reduce the government's budget deficit by reducing salaries of top officials, freezing government hiring, and taking steps to restructure the management of the state oil monopoly. [ ]

A major problem for Garcia will be reconciling his desire for social programs for the country's poor with the need to reduce the budget deficit. We concur with the US Embassy that Garcia has provided mixed signals about the direction of his fiscal policy. While

forcing most cabinet ministers to reduce expenditures, he has promised additional spending on high-priority projects, such as development funds for the guerrilla-infested emergency zones. His agricultural assistance program is not well defined and could also cause significant budgetary overruns. Finally, Garcia's success in controlling spending hinges on his ability to limit arms purchases, traditionally one of the largest components of the government budget. [ ]

[ ] Garcia's anger with foreign creditors over their alleged inflexibility regarding Peru's debt is the driving force behind his current stance on debt repayment. The President has yet to formulate repayment schedules, and the US Embassy believes he may copy Bolivia by dribbling out payments to multilateral institutions and then to government donors. Finance Ministry officials have requested that all longer term debt maturities be extended through January, according to US Embassy and press reports. A representative of the foreign bank steering committee for Peru has visited Lima to discuss current debt policy on interest payments, but Garcia's hostile public posture is impeding the resumption of negotiations. [ ]

We believe it will be extremely difficult to revive the economy without the help of the Western banking community. [ ]

[ ] many US and West European banks have repeatedly insisted they will permit no debt rescheduling until Peru accepts an IMF-supported economic stabilization program. Moreover, [ ] many bankers view Garcia's unilateral cap on debt repayment as a dangerous precedent, and as a result, some US regional banks are downgrading their Peruvian loans. Overall, credit lines for Peru have fallen by one-third to \$200 million since Garcia's inauguration. [ ]

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**Principal Insurgent Organizations****Sendero Luminoso (SL)**

- Began terrorist operations in 1980.
- Peru's largest and most powerful insurgent organization with approximately 1,000 to 1,500 armed militants.
- Maoist oriented, shuns contact with foreigners and all indigenous political organizations.
- Founded and controlled by Abimael Guzman, a former professor, whose goal is to launch a rural-based revolution with Marxist activists leading peasant forces against the central government in Lima.
- Operates almost on a nationwide scale but with principal manpower concentrations in Lima; the southern departments of Ayacucho, Apurimac, and Huancavelica; and the upper Huallaga River valley in northern Peru. [ ]

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**Revolutionary Movement Tupac Amaru (MRTA)**

- First appeared in September 1984 although claims responsibility retroactively for several terrorist incidents in 1983.
- Primarily anti-US orientation.
- A few hundred militant members.
- Open to foreign and domestic support; possibly receiving some aid from Communist Party of Peru (PCP); no evidence of any direct support from Moscow, although several suspected leaders are former Peruvian guerrillas from the mid-1960s with extensive contacts to Havana and Managua.
- Operates mainly in Lima and southern Department of Cusco. [ ]

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**People's Revolutionary Command (CRP)**

- Began operations in July 1985.
- Unclear whether new organization, breakaway faction of MRTA, or possible front group for MRTA. [ ]

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**The Insurgent Threat**

Garcia's economic difficulties are compounded by widening insurgent violence that caused over \$1 billion property damage last year, [ ]



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[ ] Sendero Luminoso, which remains by far the most potent guerrilla movement, expanded its rural areas of operation last year. Both it and the Revolutionary Movement Tupac Amaru (MRTA) have improved their capability for urban terrorism against the police, government officials, the diplomatic community, and other foreigners. The US Embassy reports that there is no persuasive evidence

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25X1 of cooperation between Peru's two major insurgent groups, but guerrilla actions last summer indicated that each group has mastered the ability to attack a number of targets at once. [ ]

25X1 So far, Garcia has indicated he plans to negotiate with insurgents seeking a peaceful solution but will implement a vigorous counterinsurgency campaign against those who refuse his overtures. He has consistently condemned terrorism, cracked down on human rights abuses by security forces, and called for reform of the country's woefully inefficient criminal justice system. In numerous speeches, Garcia has emphasized civic action and economic development so as to lessen the insurgents' appeal to the long-neglected peasantry. [ ]

25X1 In August, the MRTA publicly announced it was halting armed actions against the government and APRA. The group's primary purpose, in our view, was to recapture the public relations initiative from the President. This tactic is in line with its strategy, which centers on maintaining a positive public image. In early November, however, MRTA members attacked foreign businesses and government security forces in Lima. Moreover, the group has made a number of demands—including amnesty for jailed terrorists and termination of the current state of emergency—that the Garcia government almost certainly will not accept. Although Garcia appears disposed to negotiate with the MRTA, we believe he will not hesitate to approve harsh military reprisals against the organization if he concludes that it is irrevocably committed to armed struggle. [ ]

25X1 In contrast, Sendero Luminoso has stated publicly that the change in administrations will not affect its war against the government. The group attacked APRA officials and facilities immediately after Garcia's electoral victory and has since staged various operations in Lima and elsewhere. US Embassy reporting indicates that neither Garcia nor his top advisers hold any hope for a negotiated settlement with Sendero Luminoso and will pursue a strong counterinsurgency effort. [ ]

### The Illicit Cocaine Industry

25X1 Garcia inherits a burgeoning, illegal narcotics industry that exerts strong political and economic influence throughout the country. The industry employs thousands of Peruvians in the cultivation, production, and trafficking of coca leaf and its derivatives: paste, base, and cocaine hydrochloride. The President's public statements underscore his belief that illicit drugs threaten the nation's youth, severely retard national development, and create institutional corruption. He asserts that the traffickers' control of many rural areas undermines Peru's national security. Garcia called for a national drive against narcotics during the election campaign and was the only presidential candidate to visit university campuses to urge students to abstain from drug use. Since his inauguration, the President has vowed to press the fight until neither traffickers nor users are left in Peru. [ ]

25X1 Garcia has moved boldly to match his rhetoric with concrete actions. In August, he authorized the first joint Colombian-Peruvian-US antidrug operation—one of the largest raids in over a year against South American processing centers. The action resulted in the seizure of two cocaine laboratories, five modern aircraft, and assorted arms and communications equipment worth an estimated \$500 million, according to press reports. The US Embassy expects intensified antinarcotics raids to continue both in northeastern, and possibly southern, Peru. In addition, Garcia's Interior Minister told the US Ambassador that Peru's narcotics strategy will emphasize regional unity. Toward this end, Lima will push for antinarcotics agreements with Brazil and Ecuador to complement those already in effect with Colombia and Bolivia. [ ]

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The centerpiece of the government's campaign has been a sweeping crackdown on official corruption. According to the press, Garcia has dismissed some 200 senior police officials for suspected narcotics involvement and for incompetence and has promised to remove many others. He also is attempting to form a single, national police force from the country's disparate services. The US Embassy reports the administration also plans to reorganize the judiciary, prepare tougher drug laws, and consolidate all anti-drug efforts into one agency. Garcia probably hopes that these moves not only will facilitate the war against the traffickers but will prevent resumption of the rampant corruption that exists within the police and other government antidrug agencies. [ ]

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According to the US Embassy, Garcia's advisers formulated a land reform and crop substitution program during the election campaign that envisioned using financial incentives to attract coca farmers to areas more suited to the cultivation of legal crops. In our view, such a program would require substantial increases in funding and would be difficult to implement. Moreover, we believe that, despite the government's inducements, few farmers will sacrifice the huge profits of their illicit coca crop. To date the government has proceeded with manual eradication efforts but has yet to intensify such programs. At the present rate, we believe the government is likely to eradicate about 4,000 hectares of coca this year—only some 3 percent of total cultivated area. [ ]

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The President's commitment to the antinarcotics struggle apparently already is drawing strong reaction from the traffickers: Garcia believes his police reform measures have generated death threats against him and his family. In addition, the US Embassy reports that the narcotics mafia, in response to the joint antinarcotics operations that are interfering with cocaine trafficking out of northern Peru, is planning retaliatory actions against both Peruvian and US officials. [ ]

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Garcia is not likely to be deterred, however, from pressing forward with his antinarcotics measures. [ ]

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[ ] Garcia pledged that all those implicated—including any member of the ruling party—would be brought to justice and prosecuted to the full extent of the law. [ ]

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[ ] the President recently stated that he was particularly pleased with the positive international press treatment he was receiving for his efforts. We believe Garcia's personal commitment to the antinarcotics struggle, the strong support he is receiving domestically for his initiatives, and his desire to promote an issue that will strengthen his leverage with Washington augur well for continued progress in this area. [ ]

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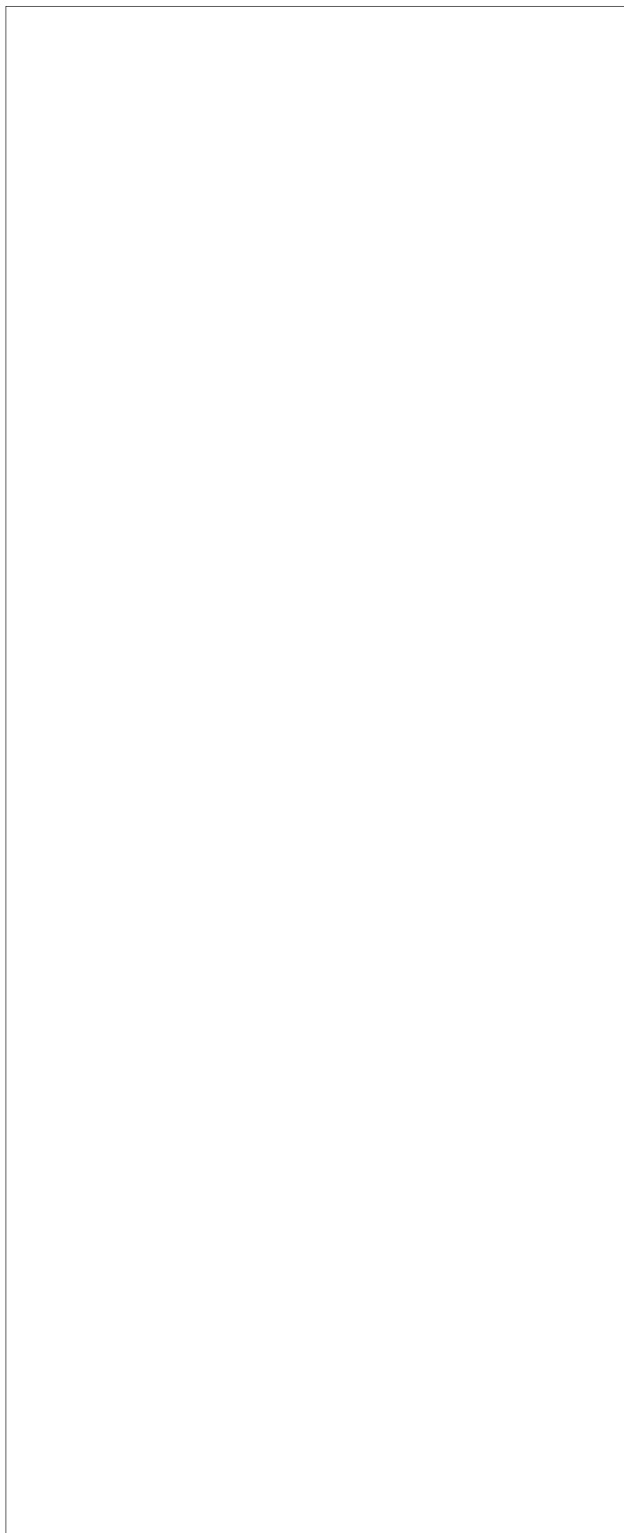
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**Contrasting Policy Toward Cuba and Nicaragua**

Since July, rivalry between Garcia and Cuba's Fidel Castro over competing debt strategies has undercut, in our view, the Peruvian leader's effort to monopolize the subject and probably will delay long-rumored plans to upgrade relations between Lima and Havana.

[redacted] Garcia is perturbed with Castro and is determined not to let the Cuban leader usurp the issue. In public speeches, he has hinted at Castro's hypocrisy in calling for a debt moratorium because Cuba has no substantial debt to Western creditors and is scrupulous in paying what debt it has. Garcia's statements also show he recognizes that a moratorium would have calamitous consequences for most Latin debtor nations. The US Embassy reports he resents attempts by Castro, whom he recognizes as being solidly in Moscow's camp, to portray debt as part of the East-West struggle, when, in Garcia's view, it is a North-South problem. [redacted]

By contrast, Garcia has been eager for cordial relations with the Sandinista government in Nicaragua. The President has publicly blamed Washington for confusing a popular revolution against injustice and despotism with Soviet penetration, and he outspokenly opposes the use of economic sanctions or any other coercive measures against Nicaragua. He has repeatedly defended the legitimacy of the Sandinista regime, claiming that it represents a nascent, albeit imperfect, experiment in democracy. The Peruvian President's approach toward Nicaragua, in our view, conforms to his notion that Latin American sovereignty needs protection from outside involvement. [redacted]

**Outlook and Implications for the United States**

In our view, Garcia's early and bold policy initiatives have created the appearance of a government with vision and determination and have placed potential adversaries decidedly on the defensive. His extraordinary popularity should continue to help ward off any serious challenges for some months to come. [redacted] In the economic area, we believe Garcia's preliminary policy decisions could eventually lead to a self-imposed stabilization program that would break the financial impasse with Western creditors. However, even in the best case, we believe economic growth in

1986 will contract from this year's 3 percent because shortages of industrial imports and foreign credit will stifle domestic investment and construction. Moreover, we estimate that inflation will reach a record 200 percent as a result of a large budget deficit. Based on current trade data, it appears that depressed prices for key exports will lead to another current account deficit next year. Meanwhile, the weak economy, political uncertainty, and nationalistic legislation almost certainly will discourage foreign investment. [redacted]

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Continued deterioration of the Peruvian economy over the next year or so is likely to add to existing strains in relations with the United States. In our view, the President probably expects growing domestic opposition in the coming months as the impact of his economic austerity measures becomes apparent. We agree with the US Embassy's judgment that continuing attacks on Washington are likely as part of an effort to distract public opinion from the economic "castor oil" the nation is being called on to swallow. We look for him to try to deflect criticism by playing on historic anti-US sentiment, which arises largely out of envy for US wealth and prosperity. In addition, Garcia probably will continue to exploit the image of conflict with Washington to bolster his nonaligned credentials as he strives to carve out a leadership niche for himself in the Third World. Finally, the Peruvian President's willingness to strengthen relations with Moscow, especially in economic and military areas, will directly affect US interests in Peru and may help legitimize such interchanges in the eyes of other democratic leaders in South America. [redacted]

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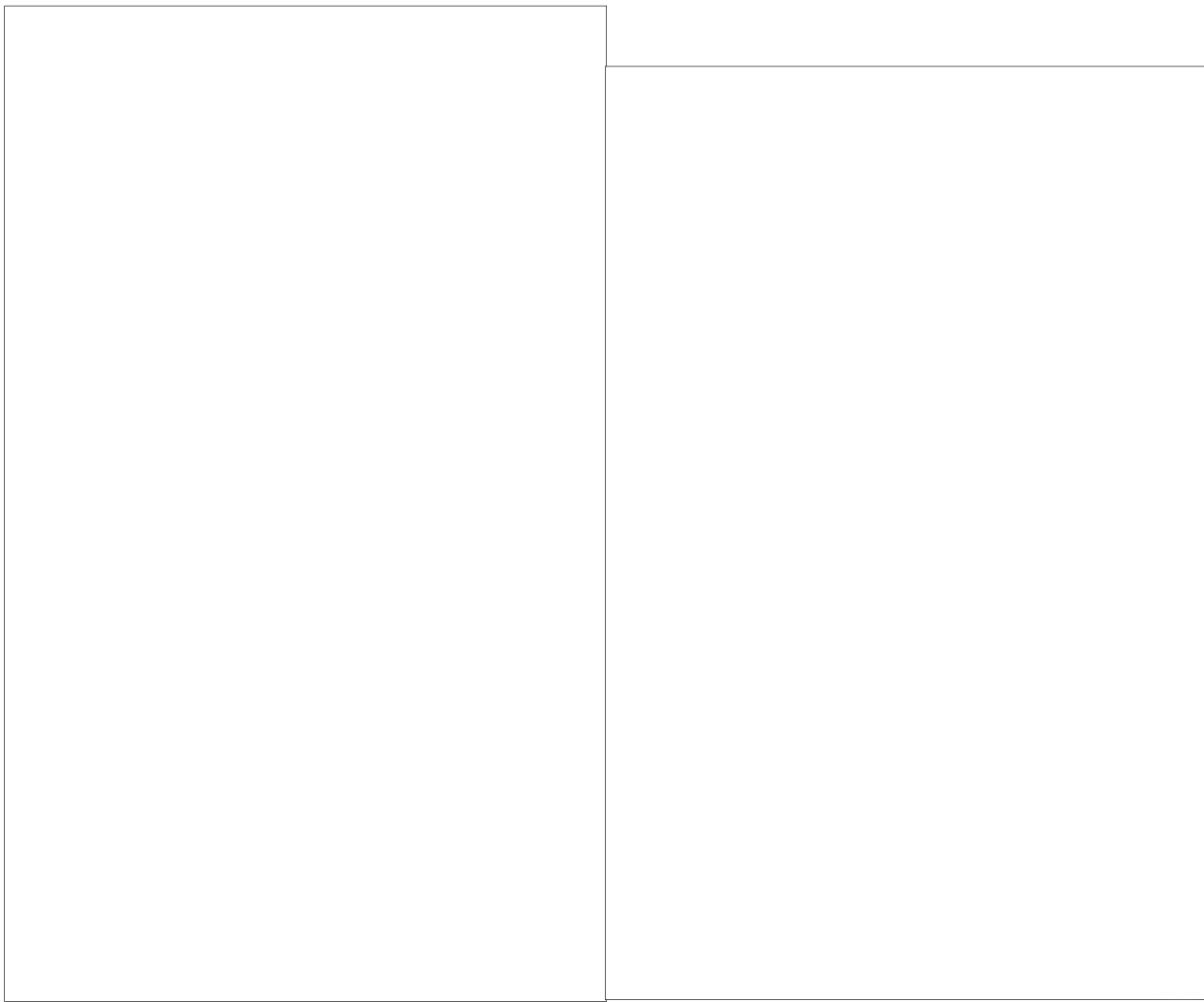
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If, however, as we expect, the economy fails to revive by the end of Garcia's first year in office, we judge that he will be forced to reassess his current approach. We agree with the US Embassy that the President is a pragmatist who understands that he cannot produce sustained domestic economic growth—and hence maintain his popularity at home—without US financial assistance and private capital investment. Consequently, should Peru's financial difficulties continue

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to grow over the next year, Garcia is likely to alter his course and opt for a more traditional economic program. Such a shift in policy direction probably would also result in a toning down of Garcia's more strident Third World rhetoric on a variety of subjects and hence facilitate an improvement in Lima's relations with Washington [redacted]

Under this scenario, for most of Garcia's first year in office he would continue to emphasize social development, income redistribution, central planning, and state control. In so doing he would continue to rely heavily on advisers associated with the leftist Velasco

military government of the early 1970s. Once it became apparent that this approach was failing, however, Garcia would initiate a second phase in which he would adopt more orthodox economic policies. A key indicator that such a shift was occurring would be the replacement of Minister of Finance Alva Castro with Javier Silva Ruete or some other more fiscally conservative economist, followed by private overtures to the IMF [redacted]

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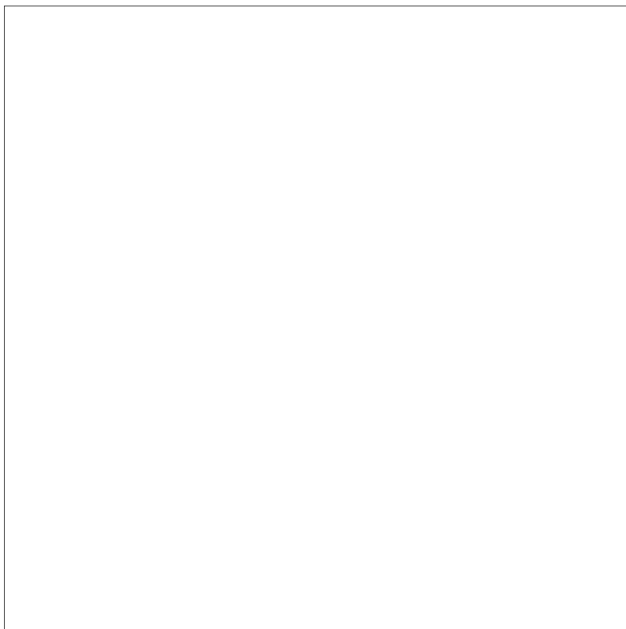
We put the odds as better than even that such a scenario will come about, but we do not discount the less likely possibility that continuing economic difficulties would lead the impetuous young President to shift sharply leftward. At home, Garcia—anxious to prevent his popularity from plummeting—might decide to intensify efforts to promote growth and job creation. In our view, increased government spending for investment and assistance programs would quickly outrun tax collection, thereby forcing the Central Bank to print money. As a result, the budget deficit could soar to a record 18 percent and push inflation beyond 300 percent, according to an econometric

forecast by a Peruvian development institute. Under such conditions, Garcia's continued commitment to bypass the IMF and stick to his 10 percent debt-service ceiling would cause creditors to cease financial support. Peru's cash bind would intensify in the face of weak exports and the likely cessation of trade credits. Importing would have to be conducted on a cash basis or through barter deals—as is already in prospect for Peru's trade with the USSR, Israel, France, and Brazil.

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